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FM AMCONSUL SHANGHAI
TO RUEHC/SECSTATE WASHDC 8475
INFO RUEHBJ/AMEMBASSY BEIJING 3242
RUEHCN/AMCONSUL CHENGDU 2335
RUCPDOC/DEPT OF COMMERCE WASHINGTON DC
RUEATRS/DEPT OF TREASURY WASHINGTON DC
RUEHGZ/AMCONSUL GUANGZHOU 0792
RUEHHK/AMCONSUL HONG KONG 2506
RUEHLO/AMEMBASSY LONDON 0057
RUEHML/AMEMBASSY MANILA 0145
RHEHAAA/NATIONAL SECURITY COUNCIL WASHINGTON DC
RUEHFR/AMEMBASSY PARIS 0036
RUEHUL/AMEMBASSY SEOUL 0641
RUEHSH/AMCONSUL SHENYANG 2326
RUEHGP/AMEMBASSY SINGAPORE 0309
RUEHIN/AIT TAIPEI 2124
RUEHKO/AMEMBASSY TOKYO 0852
RUEHUM/AMEMBASSY ULAANBAATAR 0015
RUEHGH/AMCONSUL SHANGHAI 9141

UNCLAS SECTION 01 OF 03 SHANGHAI 000015

SENSITIVE
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DEPT FOR EAP/CM
NSC FOR MEDEIROS, LOI, SHRIER
STATE PASS USTR FOR STRATFORD/WINTER/MCCARTIN/KATZ/MAIN
USDOC FOR ITA DAS KASOFF, MELCHER, SZYMANSKI, MAC/OCEA
TREASURY FOR OASIA/INA -- DOHNER/HAARSAGER/WINSHIP
TREASURY FOR IMF -- SOBEL/CUSHMAN
STATE PASS CEA FOR BLOCK
STATE PASS CFTC FOR OIA/GORLICK
MANILA FOR ADB USED
PARIS FOR US/OECD

E.O. 12958: N/A

TAGS: ECON EFIN EINV PGOV CH MG

SUBJECT: HOT MONEY INFLOW RESTRICTIONS BEING IMPLEMENTED IN EAST CHINA

¶11. (SBU) Summary: Manipulation of trade transactions across China's borders to arbitrage anticipated renminbi movements has decreased under a new trade-transaction verification system. However, investors can still get "hot money" funds into China through a variety of loopholes -- such as transactions using Mongolian banks -- and demand has been picking up as the market prices in 2-3.5 percent renminbi appreciation in 2010. On a separate note, U.S. importers are not welcoming a Chinese program encouraging their use of renminbi for settlement of trade payments. End Summary.

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Background
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¶12. (SBU) Visiting Federal Reserve Bank of New York Senior Vice President John Clark, International Officer Hunter Clark, and Senior Financial/Economic Analyst Jeffrey Dawson met with Wachovia Shanghai Branch Managing Director and General Manager Benjamin Kinnas and Vice President Han Lin on Thursday, December ¶110. Wachovia is a major correspondent bank for Chinese counterparties, and provides export financing; the bank is involved in transactions associated with around 10 percent of China's total trade, according to Kinnas.

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Hot Money Flows Face More Hurdles . . .
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¶13. (SBU) Wachovia's Kinnas explained that the August 2008 regulations issued by SAFE have given Chinese authorities an effective tool for controlling "hot money" inflows -- capital

that investors take into the country for short-term arbitrage on exchange rates or interest rates. Lin said that the regulations have plugged the loophole through which discrepancies in trade invoicing were used to transfer foreign capital into China through the trade account; inflows of capital under the capital account continue to be tightly restricted. (Note: China allows free conversion of foreign currency into renminbi, provided the foreign exchange is earnings from exports. Prior to the new system, firms could agree with overseas traders to artificially hike the value of exports -- "over-invoice" -- and use the excess trade "earnings" in China for investment or to speculate on renminbi appreciation. End note.)

¶14. (SBU) The 2008 regulations require banks to hold in escrow any foreign currency deposited by an exporting company into its bank account until the earnings are validated as coming from legitimate export transactions. After putting the funds in escrow, a bank must log into a General Administration of Customs database to confirm that the firm has legally registered exports valued at or above the value of the foreign currency deposit; the bank will then note in the Customs database the amount of foreign currency being deposited, and Customs will subsequently subtract this amount from the total. (Note: Kinnas commented that the new requirements have required him to staff an export-transaction verification desk. The added operating costs are not exorbitant, but this mandate is an example of how Chinese authorities are starting to push policy compliance monitoring responsibility onto firms. End note.)

===== . . . But Can Still Get Through =====

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¶15. (SBU) Loopholes remain in the system that allow investors to avoid the US\$50,000 per person, per year limit on foreign exchange conversion, said Kinnas. One favorite legal route is transferring money through Mongolia. Under a bilateral trade agreement between China and Mongolia, an unlimited amount of dollars can be converted into renminbi in Mongolian banks. One need only open a dollar account in a Mongolian bank, transfer in dollars, convert these into renminbi, and then transfer the renminbi to a Chinese bank, said Kinnas.

¶16. (SBU) In another legal channel, people can convert foreign exchange into renminbi in the overseas branches of the two Chinese banks that have offshore conversion licenses -- Bank of China and Industrial and Commercial Bank of China. For example, it is possible to use an "overseas remittance program" in the Bank of China New York Branch, although there is a limit of US\$50,000 per transaction and the bank "gouges" remitters on the exchange rate, according to Kinnas.

¶17. (SBU) More in the grey area, said Kinnas, some investors use family and friends to make multiple transfers of US\$50,000. Kinnas also hinted that Bank of China managers can be paid bribes to facilitate illegal foreign currency transfers.

===== Renminbi Appreciation Expectations Reflected in "Trade Finance" =====

¶18. (SBU) Through summer 2008, market anticipation of renminbi appreciation was reflected in high demand in China for borrowing renminbi against future earnings of dollars, said Kinnas. Typically borrowed in 180-day increments, this was officially labeled trade financing. When renminbi appreciation expectations evaporated with China's falling export outlook following the fourth quarter of 2008, this "trade financing" also fell off. As a result, it created the appearance that the fall in trade financing was greater than the fall in trade. With the market anticipating a 2-3.5 percent renminbi appreciation in 2010, said Kinnas, China-based companies are again approaching Wachovia to set up similar financing arrangements.

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An Experiment: Are Bank Transfer Rules Enforced?
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¶9. (SBU) SAFE is using technology to better control foreign currency transfers under the capital account, said Lin, illustrating his point with an experiment he undertook. He transferred from overseas three US dollar amounts to accounts he opened in his name in three Chinese banks: to a Bank of China branch, he wired US\$25,000; to another of China's major banks, he wired US\$24,000; and to a small city-level bank, he wired \$2,000. He then attempted to convert the US dollars into renminbi in each of the banks. He successfully converted the first two amounts, but when he applied to convert the last US\$2,000, the local bank informed him that he would only be able to convert US\$1,000. They were aware that this was his limit, the bank staff told him, by consulting his foreign exchange records using a special computer terminal provided by SAFE.

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RMB Internationalization Going Slowly

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¶10. (SBU) Few of Wachovia's trade finance customers are moving toward using renminbi to settle payment of trade transactions, said Kinnas. There are two reasons. First, a company importing from China that agrees to pay in renminbi essentially takes on foreign exchange risk from the Chinese exporter. When foreign companies take on such risk, they often look to offset it with a foreign currency derivative, locking in their expenses and revenues. However, there is no liquid, transparent market for Chinese renminbi forwards or exchange rate swaps. Second, the system for settling trade payments in renminbi is not user-friendly -- only certain banks and specific companies have been designated as part of the pilot. In addition, Wachovia offers additional services, such as trade finance, in addition to its currency clearing business, so customers get one-stop shopping.

¶11. (SBU) Outside China, Chinese banks are contacting branches of non-Chinese banks to pressure them to open offshore renminbi accounts, apparently in response to a mandate from the People's Bank of China (PBOC), said Lin. The Chinese banks are not concerned if the foreign banks have renminbi to deposit in the accounts, and appear focused only on increasing the numbers of the accounts. In some cases, a Chinese bank has suggested that opening an offshore renminbi account will give that Chinese bank "face," and therefore will facilitate the foreign bank's long-term business operations in China.

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Comment
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¶12. (SBU) From the East China perspective, China's leaders are still fighting an uphill battle to control foreign exchange inflows into China, despite more adept use of technology to monitor transactions. Because many local governments are desperate to see a turnaround in exports -- and the jobs and revenue that exports bring -- there is little motivation on a local level to strictly monitor foreign exchange inflows that are nominally tied to trade, even if some are falsifying trade records to import funds. In turn, these foreign currency inflows, to the extent that they outrun the PBOC's sterilization efforts, will contribute to inflation that banking and finance officials increasingly cite as their primary concern in 2010. Efforts to internationalize the renminbi, which could eventually lead to lower foreign exchange reserves buildups, do not appear to be making much headway at present.

¶13. (SBU) The Federal Reserve Bank of New York has cleared on this cable.CAMP